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Financing the Future: Trends and Challenges in Data Center Infrastructure for AI

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Introduction

Like drilling rigs were the backbone of infrastructure during the Texas oil boom in the 20th century, data centers are central to the digital infrastructure of today's economy. Developers are rushing to build data centers to capitalize on the immense demand for data, the oil of our digital economy. Data centers represent a new asset class that is expected to triple in size globally by 2034, from $256 billion to about $776 billion.

Accordingly, we have recently seen intense activity in debt and equity transactions that finance the construction and acquisition of data centers. This strong investor appetite is expected to continue in 2025, driven by the increasing demand for higher computing power and heavier AI workloads amid fierce global competition.

Credit: Adobe Stock

Data Center.

Unique Features of Data Center Financings

Many data center financings share the following notable characteristics:

1. Capital Hurdle

Data centers require massive upfront capital investment. The average total capital cost for a hyperscale data center can easily exceed $500M. While some market players in the hyperscale space can use their balance sheet or their access to capital to secure advantageous financing, the remainder often need to enter into partnerships and other joint venture structures to raise the required funding. More complex, hybrid financing structures are often necessary to both spread lender risk and contain capital costs.

2. Technology Risk and Scarcity

Digital infrastructure is generally responsible for approximately 30 to 50% of total data center capital costs. The risk of these key assets becoming technologically obsolete is both substantially higher and less predictable relative

to other asset classes. This uncertainty means financing structures need to account for future upgrades, the need for continual investment in technology, and future supply disruptions. Asset depreciation is also more difficult to model.

3. Exit Risk

Many data centers are relatively bespoke projects designed to accommodate the unique needs of their customers, often involving proprietary intellectual property. This distinctiveness complicates the practical viability of refinancing a troubled project or transferring the project to a third-party and discounts collateral value in a foreclosure scenario. Fortunately for secured lenders, developer defaults are rare and tenants are incentivized to renew their leases due to their high sunken costs.

4. Energy Demand

Data centers are a 21st century opportunity sailing into the headwinds of our mid-20th century energy infrastructure. Customers require a "24/7" continuous, reliable, and cost-efficient power supply. These are energy-intensive operations – a recent report from the U.S. Department of Energy predicts that data centers will account for between 6.7% and 12.0% of total U.S. electricity consumption by 2028.

Financing Structures

Data center financings can be structured based on principles from several areas of finance, taking into consideration their respective trade-offs.

Generally, borrowers are bankruptcy-remote special purpose vehicles formed by developers to shield project risks and liabilities from their corporate balance sheets, and to comply with restrictions under their upstream corporate credit facilities and internal, risk management policies. Lenders vary based on the financing structure, but they commonly include a group of commercial banks and institutional investors.

Specific Types of Financing

1. Structured Financing

Structured financing, and asset-backed securitizations (ABS) in particular, are a common and attractive financing option for both non-investment grade and investment grade developers needing to raise large amounts of long-term capital.

The issuer of the securities typically owns project companies that own or lease the securitized data centers. The collateral package is focused on the lease payments due from data center tenants. ABS lenders rely on financial covenants, resulting in borrowers being subject to fewer operational restrictions compared to a typical project finance transaction.

2. Project Financing

Limited recourse project financing is commonly the preferred option for data center-backed transactions, but this structure often entails greater complexity, substantially higher transaction costs and longer closing timelines. Project financing is often used to provide construction debt for data centers that are still in development or those with substantial stranded asset risk if the project's revenue contracts are breached or terminated.

Project finance lenders expect stable cash flows from one or more long-term offtake contracts. And borrowers are generally subject to greater oversight and control by the lenders, resulting in tighter covenants and borrowing conditions.

3. Real Estate Financing

Many data center financings are based on a traditional commercial real estate loan

structure. This model is well understood by the market and includes customary lender protections including mortgages or deeds of trust and collateral assignments of leases and physical improvements.

4. Corporate Financing

Conventional corporate debt financings, including transactions for which the issuer is a REIT, typically close faster with lower transaction costs and usually provide developers with better economic terms with their existing relationship banks. Developers also retain considerably more operational flexibility as compared to a typical project financing. However, corporate debt financings may come with their own legal and regulatory risks, together with ongoing reporting and compliance costs that may be significant.

5. Equity Financing

Equity financings provide the most operational flexibility, but developers forego the benefits of leverage and put their own cash at risk. Developers, especially those with a strong track record, may capitalize on private placements or public equity issuances to secure long-term equity financing. While providing operational flexibility, many equity financings share the same legal, regulatory and reporting risks associated with corporate debt financings.

Diligence and Underwriting Process

Some of the key factors in lenders' due diligence and underwriting process for data center financings include:

1. the type and features of the data center; for example, (i) powered shell and carrier hotel data centers generally have a better risk profile than turnkey facilities due to potential cash flow volatility and (ii) newer, larger, and more efficient assets are viewed more favorably;
2. creditworthiness and concentration of tenants, and stranded asset risk if there are no viable substitute tenants;
3. lease terms and churn rate; for example, hyperscale facilities often have greater credit quality tenants, longer leases and lower churn rates as compared to colocation data centers; and
4. location of data center, and whether there is low-cost and reliable access to power and water.

Challenges

Regardless of financing structure, both developers and financing parties continue to grapple with how to address the following core concerns in the space:

1. Construction Risk & Capital Costs

Approximately 80% of the time, major players owning a large portfolio of existing data centers obtain unsecured debt at the parent company level - unsecured bond issuances are common.

But smaller cap entities and new market entrants need to get lenders comfortable with the construction risk for these capital-intensive projects.

The solution is usually a secured financing and sometimes also raising equity through a joint venture, REIT, or other investor group. To mitigate the resulting higher capital costs and risks, developers sometimes try to refinance the data center at project completion with lower cost, long term bond issuances.

To the extent that they own other operational assets, these developers can also resort to structuring a portfolio financing by granting lenders

a security interest in those lower risk assets. In some cases, developers may adopt more creative approaches, such as using an asset-based lending structure that is secured by graphics processing units as collateral, especially in light of their increasing value and scarcity.

2. Required Reserves

Data centers are capital-intensive and require periodic upgrades to stay competitive, meet customer demands, and adhere to regulatory requirements. Therefore, many lenders require that the developer maintain a substantial reserve to ensure that funds are available for future infrastructure upgrades.

In the case of leased data centers, tenant nonrenewal is an additional risk so these lenders will also usually require borrowers to maintain a six-month to one-year lease payment reserve.

Additional reserves to fund required tenant improvements, pay property taxes, insurance and other project costs may also be required, which further constricts distributable cash.

3. Energy Demands

Perhaps the most important challenge for data center financings is securing a source of reliable, cost-effective power at scale. One option to bolster reliability is to utilize "behind-the-meter" generation systems. However, the substantial cost to build, operate, and maintain a dedicated power system remains an impediment for many developers.

Also, the intermittency of renewable energy presents an additional challenge. Battery storage mitigates this problem, but most data centers continue to rely upon retail purchases from the existing grid.

To address the key concern of price certainty, developers are increasingly entering into virtual power purchase agreements, which are essentially long term financial hedging agreements whereby the data center purchases energy at an agreed-upon price from a separate energy generation project in exchange for renewable energy credits that can be further monetized by the developer.

4. Diversification

In addition to single, stand-alone financings, developers may seek to obtain portfolio financing for data centers to obtain greater risk diversification through cross-collateralization and to achieve lower transaction costs, especially when grouping together projects of different sizes and risk profiles.

Furthermore, portfolio financings usually require compliance with financial covenants at the holdco level, rather than at the project-level, which, together with relevant thresholds and exceptions in the covenants and borrowing conditions, may avoid an event of default that would otherwise be problematic if any individual data center were to be financed by a stand-alone financing.

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